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Dear Mr Roberts

Commercial in confidence

JGN 2015-20 access arrangement draft decision

Thank you for your letter dated 8 January 2015 and for the teleconference discussion with your staff on 16 January 2015. In the attachment to this letter I provide further information in response to your letter and on the matters raised in the teleconference.

Please contact us if you would like to have a follow-up discussion on the matters covered in the attachment.

Yours sincerely



Robert McMillan
General Manager Regulation

ATTACHMENT

1. In this attachment we provide further information in response to the AER's letter of 8 January 2015¹ and on the matters raised in the teleconference between JGN and AER staff on 16 January 2015.

1. Related party margin

2. In the draft decision the AER proposes to disallow the related party margin paid to Zinfra on the grounds that "JGN did not set out why a Zinfra margin is incurred or how the margin is calculated".²
3. In addition, in your letter of 8 January, you cite the second paragraph of clause 15.1 in Annexure A of the Field Service Agreement (**FSA**) as supporting a view that the FSA unit rates include the Management Fee and Management Margin.³ We understand how you might come to this conclusion, however that interpretation is incorrect.

- The first paragraph of clause 15.1 is the key operative element of the clause:

In consideration of the execution and completion of the Contract Work in accordance with the Contract, the Company shall, subject to the terms of the Contract, pay to the Contractor the Contract Sum.

- That paragraph establishes the obligation on JAM to pay Zinfra the "Contract Sum", which is defined as the aggregate of:
 - all Work Order Sums
 - the Management Fee
 - the Management Margin⁴

where Work Order Sums are determined by reference to the Unit Rates.

- the purpose of the second paragraph in clause 15.1 is to clarify that the payments that Zinfra receives under the contract (comprising the Contract Sum, including sums determined by reference to unit rates) are Zinfra's sole compensation for performing the contract unless there is a specific provision elsewhere in the contract.
 - the contracted unit rates in the FSA are the same as the market-tested unit rates for the northern region that the AER has accepted as efficient.
4. We have previously provided extensive information on JGN's outsourcing arrangements in response to clause 9 of the AA RIN⁵ and in AAI appendices 4.1, 4.2 and 6.8⁶. We also presented material to AER staff on 28 November 2012 and 27 November 2013 in the course of

¹ AER, letter from AER's Sebastian Roberts to Jemena's Robert McMillan, 8 January 2015.

² AER, Attachment 6 Capital expenditure (Confidential) – Jemena Gas Networks 2015-20, p. 6-26.

³ AER, letter from AER's Sebastian Roberts to Jemena's Robert McMillan, 8 January 2015.

⁴ FSA, Annexure A, clause 1.1.

⁵ See responses to clauses 9.4 and 9.5 in particular.

⁶ For discussion of the Management Fee and Management Margin, see section 4 of appendix 4.1 and section 4.2.3 in particular; pages 3 and 4, and section 7 of appendix 4.2; and section 1 of appendix 6.8.

pre-submission engagement. That material was reproduced in attachment A to AAI appendix 4.1. In summary:

- the Zinfra Management Fee covers Zinfra’s costs of managing the works programme and providing quality management and other functions in the southern region (“the management services”). The scope of the management services is specified in schedule R1.1 in FSA Annexure B. The management services that Zinfra performs in the southern region correspond to functions that JAM performs in the northern region.
- the management services are distinct from the unitised construction work and repair and maintenance services. The cost of providing unitised construction work and repair and maintenance services is covered by the contract unit rates, which are ultimately reflected in the Work Order Sums.
- the Management Fee payable to Zinfra for providing the management services is defined in clause 1.1 of FSA Annexure A— [c-i-c] for the first contract year.
[c-i-c]

[c-i-c]

5. We have allocated the Management Fee and Management Margin between capex and opex on the basis of an assessment of the functions of Zinfra’s personnel who perform the FSA. Approximately 80 per cent of the total is capitalised.
6. Consistent with the fact that new connections work is the dominant capital work performed by Zinfra, we include the capitalised amounts of the Management Fee and Management Margin in the build-up of the fully-costed unit rates that we use to forecast the cost of new connections.⁸

2. New connection unit rates

7. In the draft decision the AER based its forecast of new connection capex on historically observed unit rates for new connections because it did not consider it reasonable to base the unit rates on one year’s activity mix data as we had done in our initial proposal.⁹
8. In our teleconference on 16 January 2015, we described the work that we have done to develop fully-costed unit rates for forecast new connections that take proper account of the costs of current outsourcing arrangements and reflect the actual mix of activities over a longer period than a year.

7

[c-i-c]

as stated on page 3 of AAI appendix margins for contracting businesses

as demonstrated in AAI appendix 6.8.

⁸ New connections account for approximately 85 per cent of the value of capital works performed by Zinfra.

⁹ AER, draft decision, pages 6-21 and 6-22.

9. Taking into account the data that is available, we favour using the following basis for the components of the fully-costed unit rates for (A) mains and services, and (B) meters.

A. Mains and services:

New connection unit rates – basis of rates for mains and services

Cost component	E to G, New Estates, Medium Density, and I and C Tariff	I and C Contract
Contractor	4 year average of volume mix x current contract rates	4 year average
Restorations	4 year average	
Materials	4 year average	
Management fee	RY14 actuals	
Internal labour	RY14 actuals	
Quoted works	RY14 actuals	

where:

- 4 year average is the average of RY11, RY12, RY13 and RY14 values
- direct overheads are included separately in the capex forecast
- Management Fee, internal labour and quoted works – only one year of relevant history is available due to changes related to new contract and contract management
- quoted works under the contracts include: traffic control, major roads works, Night works, additional contract hours, etc.

B. Meters:

New connection unit rates – basis of rates for meters

Cost component	E to G, New Estates, Medium Density, and I and C Tariff	I and C Contract
Contractor	4 year average	4 year average
Materials: gas meters	4 year average	
Materials: hot water meters	Based upon latest purchase costs	
Materials: meter data loggers	4 year average	
Internal labour	RY14 actuals	
Quoted works	RY14 actuals	

where:

- 4 year average is the average of RY11, RY12, RY13 and RY14 values
- hot water meters – since product failure, tender responses have led to a cost increase. Using 12 months average plus increment for new meters costs
- MDL volumes are determined from 4 year historical average per connections (approximately 21 customers per MDL)

- direct overheads included separately in the capex forecast
- quoted works include special contractor costs (MDL-related only).

10. We compared the resultant average contractor rates for mains and services against:

- the rates that we submitted in our initial proposal
- the rates that would result if averages were based on three years of historical data instead of four
- the actual rates observed for 2013-14,

and noted that the average contractor rates are relatively insensitive to the period over which the activity mix is calculated: one, three or four years.

11. Your staff raised one question: why do we propose to use the four year average cost for gas meters rather than current contracted meter costs applied to a four year average of the meter mix?
12. Unlike the mains and services contractor costs, the meter contractor costs have not changed with the new outsourcing arrangements. Therefore the average of the costs for the current AA period is appropriate as a forecasting basis. It should be noted that using historical costs will account for any variation in the mix of activities.
13. You also asked if we could provide you with a copy of the model used to calculate the fully-costed unit rates. We will provide this model with our revised proposal. We have taken on board your feedback about the original model and we will improve the accessibility of the model.

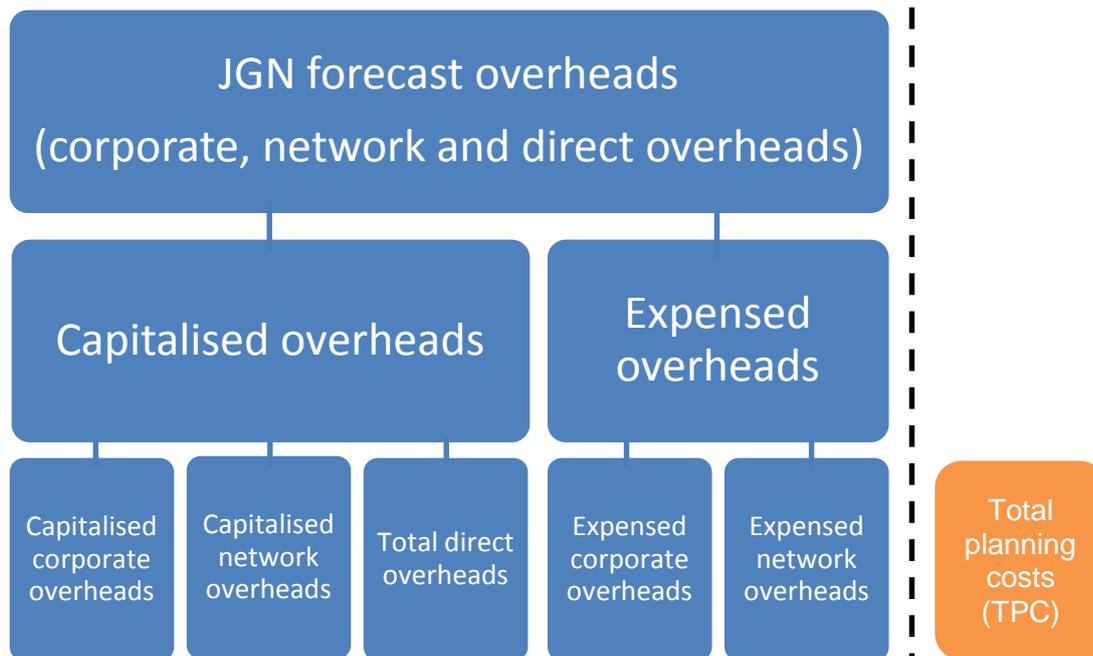
3. Government Authority Work

14. In the draft decision, the AER has interpreted our initial proposal for the cost of Government Authority Work (**GAW**) as being a forecast of gross expenditure. The AER then proposes that the forecast amount be offset in full by customer contributions on the basis of practice in Victoria where the cost of GAW is fully recovered.¹⁰
15. We confirm the statements in our letter of 12 December 2014, that there are cases where JGN does not have the right to recover the full cost of GAW and that the forecast of GAW costs in our initial proposal is the net amount after recoveries.
16. Annual GAW expenditure on JGN assets over the current AA period has been in the range \$4m to \$14m. Our initial proposal reflects the fact that, on average, we recover all but about \$0.5m of the annual amount.
17. We note your request for gross GAW and contributions data for the past five years. We will provide further detail with our revised proposal.

¹⁰ AER, draft decision, pages 6-46 and 6-47.

4. Total Planning Costs and overheads

18. JGN's treatment of overheads in the AA RIN was driven by the requirements of the AA RIN. The treatment of overheads in our AA proposal was driven by our business approach to reporting overheads, which differs from the AA RIN treatment. This difference in treatment has been the likely cause of confusion to date.
19. The figure below illustrates, at a high-level, the different categories of JGN's forecast overheads.



20. It is important to note that:
- total planning costs (**TPC**) are not an overhead cost
 - both corporate and network overheads have capitalised and expensed components
 - direct overheads are forecast to be fully capitalised.
21. JGN reports capitalised and expensed corporate and network overhead amounts on Tab 14 of the AA RIN at rows 194-196.¹¹ The components of overheads are classified in accordance with the AA RIN¹².

¹¹ Note that the overheads forecast, including the allocation of overheads between opex and capex, is produced in JGN's forecast opex model (AAI appendix 7.1). The results are then reproduced in Tab 14 of the AA RIN.

Direct overheads are included in the Total overhead cost reported at row 181 on the sheet named "3 - Capex summary" in the AA RIN. The TPC projects are reported at rows 246, 667 and 679 of the sheet named "8 -Facilities renewal & upgrade".

¹² AER, *Regulatory Information Notice under Division 4 of Part 1 of Chapter 2 of the National Gas (NSW) Law*, 28 March 2014. See section 13 of appendix C and definitions of "corporate overhead", "network overhead", "network planning" and "network control" in appendix D.

Capex/opex overhead apportionment

\$k, \$nominal	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Opex overheads	82,209	83,613	86,366	89,295	92,350	95,082	98,014
Capex overheads	17,760	18,076	18,730	19,446	20,166	20,770	21,438
Total overheads	99,969	101,689	105,095	108,741	112,515	115,852	119,452
Percentage capitalised	17.77%	17.78%	17.82%	17.88%	17.92%	17.77%	17.78%

Source: AA RIN, Table 14.3.

22. The AER accepts JGN's proposed 2013-14 capitalised corporate and network overheads of \$18.29m (estimated), \$2015 (draft decision p. 6-45). This is equivalent to \$17.76m nominal in 2013-14.
23. Capitalised network and corporate overheads are a fairly constant percentage of total JGN overheads for the forecast period. Each component of overheads is forecast using the base trend approach from the 2013-14 base year after adjustment for one-off costs. Very similar escalators are applied to each component—there are some differences in the EBA/Contract mix between overhead components which accounts for the small variations in the capitalised percentage in the forecast years, as can be seen in the table.
24. In assessing the corporate and network components of capitalised overheads the AER analyses:
- network planning costs and TPC (pages 6-44 to 6-47 and Figure 6-3); and
 - network planning costs and system planning costs (analysis referred to in AER's letter of 8 January¹³ but not in the draft decision).
25. Our concern is that these analyses would likely have led to confusing and incorrect results and conclusions. This is because none of these three cost categories—network planning costs, TPC and system planning costs—are capitalised overheads.

Network planning costs and system planning costs are not capitalised overheads – they are expensed

26. In our initial proposal it is clear that network planning and network control and operational switching (system planning) costs were 100 per cent opex.¹⁴ That classification is consistent with the nature of the expenditure.

A. The network planning function covers:

- *Asset strategy*—developing and managing the delivery of JGN's asset strategy, SIB capex plans, asset management plans, and emergency strategy and contingency plans
- *Asset class management*—developing and managing integrity plans and engineering assessments including requirement specifications
- *Asset performance validation*—monitoring and validating the technical performance of assets, managing asset risks and formulating and initiating projects for corrective actions

¹³ AER, *Letter from AER's Sebastian Roberts to Jemena's Robert McMillan*, 8 January 2015.

¹⁴ This can be seen in AAI appendix 7.1 – *Appendix 07.1 - JGN opex forecast model - CONFIDENTIAL.xlsx*. See rows 18 and 87, and 127 and 196 (for network planning costs) and rows 19 and 88, and 128 and 197 (for network control and operational switching (system planning)) in the sheet named "Calc[Opex Summary (view 2)".

- *Programme planning processes*—developing business cases and requirement specifications for capex and opex, and analysing and reporting on capex and opex
- *Maintaining asset records*—establishing and managing network maps, pipeline alignment sheets and engineering records
- *Easement management*—administrative functions including establishment of easements and managing land and survey enquiries.

B. The network control and operational switching (system planning) function covers:

- *Maintaining meter data*—processing service requests from retailers for new connections, disconnection, reconnections and special reads, and customer transfers between retailers
- *SCADA service (control centre)*—management of SCADA communications systems including planned and corrective maintenance of the systems
- *Monitoring and control (control centre)*—control room operations including monitoring operating conditions at network receipt points and in the trunk and primary systems, and at the inlet and terminal points in the secondary and medium/low pressure systems
- *SCADA planned and corrective maintenance*—performing planned and corrective maintenance on the SCADA master station, remote telemetry units and communication links.

27. Base year (2013-14) estimated capitalised network and corporate overheads comprise only part of total network and corporate overheads in just four of the 14 network and corporate overhead components as follows¹⁵:

JGN initial proposal – components of capitalised overheads

Component	Base year capitalised amount – \$m, \$nominal (estimated)	Percentage of component that is capitalised
Capitalised network overheads		
Management - O&M	3.47	26.0%
<i>Network planning</i>	-	
<i>Network control and operational switching</i>	-	
Project governance and related functions	3.31	57.7%
Quality and standard functions	-	
Other	-	
Information technology (IT)	9.73	47.7%

¹⁵ JGN, AAI appendix 7.1 – Appendix 07.1 - JGN opex forecast model - CONFIDENTIAL.xlsm. See rows 75 to 102 in the sheet named "Input\Opex (view 2)".

Component	Base year capitalised amount – \$m, \$nominal (estimated)	Percentage of component that is capitalised
Capitalised corporate overheads		
Office of the CEO	-	
Finance	-	
Insurance	-	
Human Resources	1.25	16.6%
Legal and Secretariat	-	
Regulatory	-	
Other	-	
TOTAL	17.76	

28. As noted previously the AER accepts the base year capitalised amount of \$18.29m (estimated), \$2015 which is equivalent to \$17.76m nominal in 2013-14. As shown, capitalised network and corporate overheads do not include any network planning costs or network control and operational switching costs (see italicised categories).

TPC are not capitalised overheads – they are direct capex

29. JGN’s proposal included three projects named “Planning Costs – Steel”, “Planning Costs – Plastic” and “Planning Costs – Facilities” at a total forecast cost of \$6.2 million, \$2015 gross—referred to as TPC—for the 2015-20 AA period. In our initial proposal, we allocated TPC to the facilities renewal and refurbishment category.¹⁶

30. TPC include the costs of the following activities:

- front end engineering and design (**FEED**) costs, including both internal Jemena and external design engineers and drafting resources
- site investigation costs, including geotechnical costs, pot-holing, survey
- project establishment costs, development of detailed project plans, schedules, risk assessments, etc.
- long lead item specifications, produced by design engineers (internal and/or external)
- tender documentation preparation, for detailed design, fabrication, construction and commissioning (either as separable or combined tenders)
- tender processes, including issuing and review of tenders.

31. TPC are a distinct and necessary component of capital costs.

32. JGN collects TPC together (as opposed to charging the costs directly to individual projects) as three separate projects—steel, facilities, and plastic. However, the steel and facilities components (two thirds of the forecast total) relate primarily to moderate and high complexity¹⁷ facilities renewal and refurbishment projects while the plastic component (the remaining one third) relates primarily to rehabilitation projects in the mains and services renewal category.

¹⁶ JGN, *AAI Appendix 06.04 - JGN capex forecast model - CONFIDENTIAL.xlsb*, see for example Output\AAI Tables sheet, cell K43.

¹⁷ The classification of projects is described in section 2.2 of AAI appendix 6.7.

Accordingly, it is more appropriate that TPC be accounted for within those two capex categories than treated as an overhead and allocated across capex generally as proposed by the AER. Our revised proposal will reflect that position. However, instead of presenting TPC as separate projects, we will allocate the steel and facilities costs over projects in the facilities renewal and refurbishment category and the plastic component over the rehabilitation projects in the mains and services renewal category. AER staff advised that this will enable the AER to consider the efficiency of these projects in a more complete manner.

33. Given the nature of the expenditure, and other cost categories which sound similar, it would probably be more helpful if TPC was renamed "FEED and related costs". We will make this change in our revised proposal, and explain that we have done so.

Conclusion

34. Capitalised overheads do not include network planning or network control and operational switching (system planning) costs. Nor do they include TPC. It follows that those categories of costs are irrelevant to any analysis of capitalised overheads.

Jemena Gas Networks (NSW) Ltd, February 2015.